THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

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A Tug of War Between Boom and Bust

> **"In the history of capitalism's long expansionary cycles, it is finance capital that usually rules in the final stage, displacing the inventors and industrialists who launched the era, eclipsing the power of governments to manage the course of economic events."**
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> **— William Greider, One World, Ready Or Not; The Manic Logic of Global Capitalism Simon and Schuster, 1997**

While Wall Street continues its record run, the high tech sector has begun to reel from the Asian crisis: downward profit estimates follow one after the other. In this issue, we examine whether the long-overdue shakeout in this overcapitalized and intensely competitive sector is finally beginning to take place. We find strong evidence that the day of high-tech reckoning may indeed be upon us, and we identify some of the most vulnerable companies in the sector.

The likely imminent reversal of fortune for high tech — the economy's leading engine and Wall Street's leading sector — also provides us with an opportunity to introduce a new regular feature in our letter: specific investment recommendations. We have decided to add this feature in response to numerous requests from our readers. I will continue to provide the economic analysis. Stephen Sjuggerud and Doug Noland will assist in finding the best specific investment vehicles to profit from the global economic trends and conditions I identify. (A brief profile on Mssrs. Sjuggerud and Noland is on page seven.)

The latter part of this letter is devoted to examining the miraculously shrinking budget deficits in the EU, where the number of countries now qualifying per that criterion has jumped from three out of 15 to 14 out of 15. We find it is no miracle at all, but instead largely thanks to lower interest costs, not fiscal restraint. The inescapable conclusion is that Europe's sky-high unemployment will not diminish with monetary union, but rather continue to grow as long as politicians shy away from adopting meaningful tax and labor reforms. This further stacks the odds against the likelihood of a *fundamentally strong* euro. We do expect the euro to strengthen next year — but only because of cyclical dollar weakness on the horizon, not because of sound economic fundamentals on the part of the EU countries.

BUT WHAT ABOUT EARNINGS?

After a breathtaking rally encompassing large caps as well as small, blue-chips and computer-chips, profitable companies and companies whose earnings can only be imagined, the market now finds itself back to another season of earnings reports. We have a difficult time believing it will be bullish.

Oddly, this new bull run in U.S. stocks follows on the heels of the worst profit reporting season in many years. According to *The Wall Street Journal*, fourth-quarter earnings for 1997 were on average down 2.8 percent. Yes, down, not up — and that against the background of a still-booming economy. What to expect, then, when the economy slows?

We see considerable investor risk as the season for first-quarter earnings reports arrives. Importantly, disappointing fourth-quarter profits were not a one-quarter aberration, but indisputable evidence of an overall deteriorating profit environment. Undoubtedly with considerable "guidance" from companies' management, Wall Street analysts have been racing to cut earnings estimates for 1998. While this is certainly part of the old game of investor deception to assure earnings "beat estimates", we see much more at work.

For years now, Wall Street has trumpeted the stock market boom as a healthy earnings phenomenon. And for years, it was hard to dispute this notion, although we have, nonetheless, explained at great length that most of the perceived earnings miracle was the product of collapsing interest costs and creative accounting. As bullish investors have been happily extrapolating profit growth to infinity, we have warned repeatedly of its unsustainability and certain disappointment.

Well, the profit boom has ended.

But Wall Street has become very adept at explaining away company-specific and industry-wide earnings shortfalls. In fact, it seems to permeate current research. And, in today's liquidity-driven market, we would not be too surprised that analysts and investors alike share an illusion that profit troubles are but a temporary Asian-related "valley" that will be easily crossed on the path of endless prosperity. Indeed, it is in the nature of great speculative waves to maintain delusions of grandeur in the face of worsening conditions.

How long this great deception holds, we have no idea. In the long term, however, market prospects are in every way held hostage to deteriorating profits. With this in mind, we encourage investors to recognize that today's profit deterioration signals significantly less opportunity and much greater risk.

JECKYL AND HIDE FINANCIAL MARKETS

Looking at the extremely checkered picture of the world economy and the booming financial markets, an old adage comes to mind: If you are not confused, you don't understand the situation. The contrasts are unbelievable. Half the world is in a boom; half is bust.

Japan is slipping into recession. The news from Southeast Asia spells financial and economic disaster. Including China and India, Asia represents about 30 percent of the world economy. Economies in Europe are generally recovering, but overwhelmingly on the back of exports. As to the U.S. economy, the world's locomotive, it continues to boom.

Never before has there been such a vast contrast in the forces impacting the world economy. What will happen to the overall world economy? Stock markets, racing to new highs, apparently see nothing but reasons to celebrate. Worries about the effect of the Asian upheaval have given way to ecstasy about its stimulative effects on the U.S. and European economies via lower inflation and interest rates. The new view is that the spillover effects from the Asian crisis will keep a lid on global inflation without undermining the global expansion, heralding prolonged nirvana for the financial markets.

The economies of Japan and Southeast Asia are becoming a sure drag on the overall world economy. How big a drag, we shall find out in the coming months. The exuberance in the global stock markets essentially implies a fairly rapid recovery in Asia. Considering Japan's prolonged recession since the bursting of its bubble in 1990, we can only express our amazement. In our view, the trade effects of the Asian crisis on the rest of the world are only just beginning to show up in the statistics. Their indirect and immeasurable impact on pricing power, and thereby on profits and capital spending, will probably be as important as its adverse impact on U.S. and European exports.

As to Europe, we note a flagrant contradiction in the assessment of its global impact. Its accelerating growth is widely hailed as a prop for the world economy. According to the associated trade projections showing a soaring current-account surplus, however, it will overwhelmingly be export-led growth, which implicitly makes Europe an economic drag on the rest of the world.

JUST ONE LOCOMOTIVE FOR THE WORLD

More than ever, this leaves the U.S. economy as the world's one and only potential locomotive. Americans spend in excess what the rest of the world produces in excess. It has worked very well again in the last two, three years, even with a sharply rising dollar. But how much longer can this hold, given projections of a rapidly

widening U.S. trade and current-account deficit? By hurting U.S. economic growth, it is sure to rock the dollar.

U.S. economic and employment growth over the last three years have been the envy of the world. The economy appears strong beyond belief. But while Mr. Greenspan and the Wall Street bulls see an economy in excellent health and balance, we see behind this strength unsustainable imbalances and stimulatory forces.

On closer look, this U.S. expansion has been driven by two spending components. The one is explosive growth in high tech, and the other is overconsumption, fueled by heavy borrowing and prodigious wealth effects from the booming stock market. High tech has been accounting for one third of real GDP growth and about one fourth of employment growth. The price deflator for high tech prices was down a record 16 percent y/y in the fourth quarter. Ex the tech sector, real GDP was up a moderate 2.5 percent.

While many American economists speak of disinflation or even deflation, we see the precise opposite in action: a panoply of powerful stimulatory forces. Broad money and bank credit growth of 9-10 percent; sharply lower long-term interest rates, further substantial wealth effects from a new leap in stock prices; a massive lift to consumer purchasing power from the plunge in oil prices; the biggest jump ever in mortgage refinancing; and record-high tax refunds. Adding all these items up, one realizes that the U.S. economy in general, and consumer spending in particular, have been treated to most prodigal stimulation.

Contrary to the silly talk of disinflation or even deflation, the U.S. economy is clearly in the grips of rampant inflation in the sense of excessive demand stimulation, including demand for financial assets. In line with Austrian theory, we see the essence of inflation not in rising price indexes but in the circumstance that money and credit are supplied in excess of economic activity, calling forth serious imbalances and maladjustments in the economy and the financial system. Another big contributor in particular to the asset inflation has been collapsing demand for low-yielding money balances, resulting in increasing money velocity.

The most striking and most ominous imbalance in the U.S. economy is of course its large and growing trade deficit. It used to be elementary knowledge in economics that such a deficit reflects an excess of spending over domestic output, and that its existence implies inflationary credit creation.

Just as clearly, the prolonged boom in the financial markets has to rank as rampant asset price inflation. Given a steep decline in U.S. personal savings, the surge in financial asset prices has essentially been fueled by excess liquidity. In turn, the sharply lower savings suggest that the huge wealth effects from the booming stock market have been crucial in buoying consumer spending and economic growth. Remember that a ten percent stock market move adds more than $1 trillion of perceived wealth in a market place with unprecedented public participation.

Lately, the asset inflation in the financial markets is also plainly spilling over into the real estate markets. Manifest overheating features are soaring home sales and housing starts, plus a resurgence of speculative activity in commercial real estate (see last letter).

A TRADE SHOCK IN THE MAKING

How will this end? In the markets there is a lingering fear that rising consumer and producer prices will eventually force the Fed to hike its rates. It is our long-held opinion that for fear of triggering a market crash, the Fed is most anxious to avoid any serious monetary tightening. Moreover, we think that intense global competition and U.S. wage trends will prevent a major rise in inflation. Loose money is going to stay. The greatest danger for the U.S. economy and consequently for the U.S. dollar looms, in our view, not in the price indexes but in the trade balance. Trended data show that actual import volumes are soaring while exports have stalled out in recent months. In January, the trade deficit reached a new high of $12 billion. But price effects hide a truly dramatic worsening. Import prices have collapsed at a 9.4 percent annual rate, versus a 4.2 percent rate of decline in export prices. This virtually guarantees that net exports will subtract one or two percentage points from GDP growth in the first quarter.

On the other side of the ledger, household spending and housing are booming in the wake of robust income growth. Not for long, we assume. There is a lot of hot air in these data, owing to the unusually mild winter. Through the seasonal adjustment, in particular, variations in weather can make a huge difference. Unadjusted housing starts, for example, are in January puffed up by 40 percent. The unadjusted employment figure is raised by a staggering 2.2 million. This means that a decline in employment from December to January of only 1.9 million translates through seasonal adjustment into an increase of 300,000 which correspondingly distorts spending and income figures. In its March report, the German Bundesbank explicitly mentions that the recent improvement in German unemployment is overwhelmingly weather-related. Seasonally adjusted, the y/y increase has plunged from 375,000 in December to 150,000 in February. But unadjusted, it has remained stuck at 4.82 million.

TECH TROUBLES

Earlier we mentioned that high tech has accounted for one third of U.S. GDP growth. More than anything else, it is high tech that explains why the U.S. economy has been able to sustain faster growth with declining inflation than economists ever believed possible. But the business cycle has therefore not disappeared. To the contrary: With steep downturns in 1985 and 1990, high technology has proved more volatile than the automobile or the building industry. By vertically taking off in 1995, it really saved the present business cycle from early exhaustion.

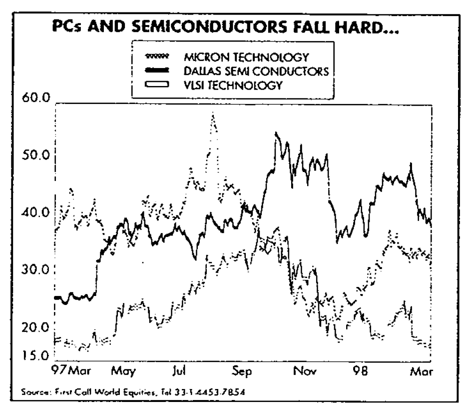
How long will it yet last? For perspective: By 1996, 107 million computers were in use in the United States, compared with 22 million in Japan and 16 million in Germany.

For some time, we have warned repeatedly of a developing, painful industry-wide shakeout in technology resulting from truly unprecedented global capacity growth throughout. Collapsing prices across the board in the sector are the predictable consequence of such gross overinvestment.

In the United States, nevertheless, absolute euphoria permeates again the perception of the technology industry. It is now critically important to differentiate between the truly wonderful environment for purchasing and operating PCs and related products (a most extraordinary buyers' market) and an absolutely cut-throat business environment with companies witnessing a stunning evaporation of pricing power, margins, and profits.

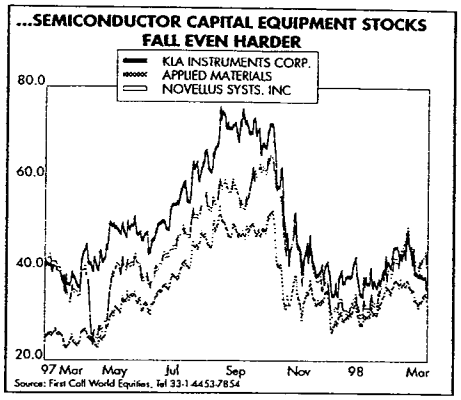
As an example, IBM recently cut the price of its 300GL PC with a 233 megahertz Pentium II chip to $1,099, slashing another 12 percent from its already aggressively discounted price from the previous month. A similarly equipped off-brand machine is priced at $850. Competitive price cuts now occur almost daily as industry players try to sell bulging inventories. Furthermore, prices for notebooks and higher-end servers, where margins had been holding, now follow desktop prices in a free-fall.

Back-to-back bombshells hit investors in early March as industry leaders Intel and Compaq both warned of disappointing earnings for the first quarter. This news collided head-on with investor exuberance that had led to 20 percent year-to-year gains in the Semiconductor, NASDAQ 100 and Morgan Stanley High Tech indices. While Intel and Compaq suffered one-day declines, the sector's general resilience and almost complete disregard of the bad news by the general market were most noteworthy. Players cheerfully downplayed the significance of the news as company-specific.



Intel actually announced that it would miss both revenue and earnings expectations significantly. With the company anticipating a ten percent decline in revenues from the previous quarter, earnings per share estimates were quickly cut to around 70 cents, a 35 percent drop from last year. Looking back at Wall Street's earnings estimates for Intel twelve months ago, the expectations were for $6.00 this year. Today, the mean estimate if $3.42 (57 percent of the early '97 estimate, and likely

still too optimistic). This will be Intel's first year of declining earnings since 1989. Meanwhile on Wall Street, even after dropping 20 percent since the recent warning, Intel stock remains 20 percent above its price of a year ago, trading with a market capitalization of nearly $130 billion (estimated total 1998 worldwide semiconductor sales), 23 times estimated '98 earnings and 650 percent of trailing revenues.



...SEMICONDUCTOR CAPITAL EQUIPMENT STOCKS FALL EVEN HARDER

Soon after, Compaq announced that it would break even for the quarter. This was quite a shock to Wall Street analysts who had estimated that the company would earn $525 million, or fully 35 percent more than the $387 million earned in last year's first quarter. However, this news came as no surprise to the few bearish analysts who had quite accurately noted ever-bulging stocks of unsold PCs at wholesalers and retailers, evidence of an increasingly desperate attempt by the major manufacturers to meet earnings estimates. In fact, Compaq has long been rumored the most aggressive user of chicanery in both its accounting as well as inventory and receivable management tactics. As each of the PC vendors has viewed aggressive unit volume growth as necessary for continued profitability and survival, this industry-wide race has to crest in the inevitable inventory and profit bust.

In our view, the rapidly deteriorating profit outlook for previously immune industry heavyweights such as Intel and Compaq is strong evidence that industry troubles have now made it to the top of the food chain. This is a sea change for the stock market. While, admittedly, we expected this to have developed earlier, the PC boom has been much the beneficiary of the extraordinary pricing collapse of mainly Asian made components as well as the great U.S. financial and economic boom.

Today, however, even with the U.S. boom, PC manufacturers have finally reached a point where demand-sustaining price cuts are no longer offset by lower component prices and manufacturing efficiencies. Obviously, component prices can only fall so far! And importantly, the industry has hit the wall as falling PC prices fail to stimulate ever-higher unit demand growth to offset price declines. Indeed, Dataquest has recently revised 1998 industry revenue forecasts to unchanged from last year, which would make this the first non-growth year since the mid-1980s.

For some idea of what the future holds for the PC industry, it is helpful to consider the dire straits of the global semiconductor industry. Actually, we see troublesome parallels between the recent euphoria in PC and related stocks and the wild speculative semiconductor run in 1995 that saw Micron Technologies trade as high as 94 (today it trades at 30) just as industry fundamentals were turning quite sour. Now more than two years since peak industry revenues (and an equal period of Wall Street bantering of seasonal, transitional, and inventory correction rationalizations), semiconductor prices have recently resumed their collapse. Sixteen-meg DRAM chips are now priced at a record low of $2.00, down 88 percent from two years ago and more than 40 percent from the much celebrated but fleeting rise to $3.50 in January. Most manufacturers now lose money on every chip produced.

Notwithstanding wishful but erroneous expectations that Korean and other Asian manufactures would cut back production, Asian chips flood the market and inventories continue to mount. In fact, all indications are that these producers steadfastly hold maintaining production as a top priority. After spending tens of billions on new capacity and as these economies struggle desperately for needed foreign currency, the strategy is to produce product aggressively and only hope pricing improves. With additional capacity still coming on line monthly, it is quite unlikely that meaningful profits will be achieved in this industry for years to come.

Ardent semiconductor bulls, nonetheless, have fixated on semiconductor capital expenditures that have held up surprisingly well as companies, compelled by intense competitive pressures, have aggressively invested, upgrading to equipment for 64-meg DRAM production. Conspicuously parting from the bullish consensus, Merrill Lynch analyst Thomas Kurlak, in a recent report stated," It is still not too late for investors to avoid what is shaping up to be a 64-meg bloodbath." Expanding our military analogy, today's arms race has deteriorated to a MAD (Mutually Assured Destruction) strategy in not only semiconductors but throughout the

(continued on page 8)

Action to Take This Month: Short Boxmaker C

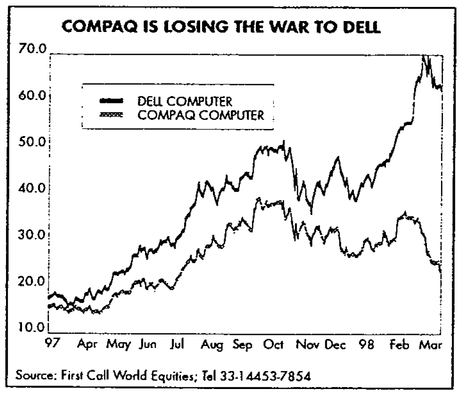
COMPAQ CAN'T FAKE IT ANYMORE

The profit outlook is rapidly deteriorating for previously immune tech industry heavyweights. Among the most vulnerable is Houston-based Compaq Computer Corporation.

Compaq has been a star in its industry, not just in its product line, but in its ability to recast negative news and to come up with creative accounting tricks so that Wall Street never gets tired of recommending its stock. But Compaq's running out of tricks, and the company's star is losing its shine on Wall Street.

Compaq has been engaged in a war of attrition with Dell in recent years battling for market share at the expense of profitability. Now, as we enter the era of the sub-$1,000 PC, things are getting very ugly indeed. Compaq looks like the likely loser. Compaq's new strategy is to broaden its base through its recent acquisition of Digital Equipment Corporation, giving Compaq some credibility in the more profitable computer server market. A risky strategy, to say the least.

Compaq paid approximately $9.6 billion for a firm with over twice Compaq's staff and one-half its revenue, and Compaq's management now finds itself with the task of consolidating two companies with very different and inconsistent cultures. In addition, Compaq is now competing with two of the world's strongest competitors in the larger computer systems arena: Hewlett Packard and IBM.



Beyond the new Digital Equipment concerns, analysts are lowering 1998 earnings forecasts on the back of several macro problems facing Compaq: a negative impact from the strong dollar, weak demand in Asia/Pacific, and more aggressive pricing competition in the corporate PC market.

In the last six months, consensus earnings estimates for 1998 have fallen from around $1.70 per share to about $0.90 per share according to First Call, putting the shares at a still-expensive 27 times upcoming earnings. The same thing is happening for 1999. Consensus estimates for 1999 were in the $2.15 range six months ago, now they're about $1.65 and falling. That puts the shares at about 15 times 1999. In reality, we think the shares are trading at a much higher forward P/E, as downward revisions of Compaq's earnings are almost certain to continue.

The share price has broken down in relation to its peer group, but the 33 percent fall in the company's share price still doesn't adequately reflect the 47 percent downgrade of earnings estimates in the last six months. Nor does it reflect future earnings downgrades, which we think are likely. All things being equal, we would much prefer to be holders of companies that analysts have to constantly re-rate higher. It's time to go short.

We've caught a glimpse of a falling star just as it is beginning it's descent. We're predicting this falling star will continue its fall. Short Compaq (NYSE: CPQ).

MICRON TECHNOLOGY ANALYST HOPES TO BE CRUSHED

Micron Technologies is a water bucket with holes in it. U.S. investors keep filling the bucket, only to see it empty itself out again. Micron happens to be uniquely positioned to take the brunt of price pressures on semiconductors coming out of Asia. Why would anyone want to own this stock, much less pay the hefty asking price of 35 times guesstimated 1999 earnings? Because it's high tech, and because we're been in a bull market. The wrong reasons. The wrong stock.

ıpaq and Semiconductor Company Micron Technology

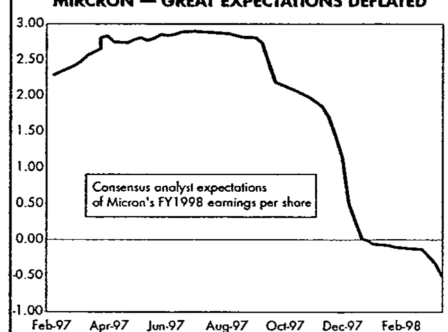
Micron makes 64meg DRAM chips, a commodity for which Korea's Samsung is the undisputed world leader. Samsung has held this title since long before the Asian devaluations got underway. In the wake of the 40 percent devaluation of the Korean won versus the U.S. dollar, Samsung's already-invincible lead and strong price advantage in 64meg DRAMs have only continued to widen — and at the direct expense of Micron.

In addition to cheaper prices arising from currency devaluations, oversupply is also hanging over the DRAM industry. No end of these margin pressures are in sight as the Koreans keep pumping chips out even below an economic cost of production. Micron is done.

These problems clearly showed in Micron's third-quarter results, which it released in mid-March. The company lost 41 cents a share when you strip out a one-time gain. But, remarkably, analysts are still positive on the stock. A recent analyst's report stated, "Micron is in DRAM for the long haul. They're good at it. They're not doing anything stupid. It's just the market has too much supply at the moment." We can only assume he's trying to unload his own shares before the bottom falls out.

Like Compaq, consensus earnings estimates for Micron have continued to fall out of the sky. Six months ago, consensus earnings estimates for FY1998 were in the $2.80 range. Now the consensus is a loss of $0.50 per share. The same holds for 1999 earnings estimates, which originally came out four months ago at $2.20 per share (see chart). Today's 1999 consensus is around $0.86.

MIRCRON — GREAT EXPECTATIONS DEFLATED



Source: First Call World Equities; Tel 33-14453-7854

In both the cases of Micron and Compaq, analysts are underestimating the magnitude of the problems ahead. This is the "not my child" syndrome. Even if securities analysts were to grasp the big picture (and we are skeptical of their ability to do that), they often mistake their beloved "babies," the few companies that they are assigned to cover, as too good to fall. Though some type of fall may happen, it won't happen to their babies.

As with Compaq, shares of Micron have not fallen nearly enough to reflect the changes in analysts' earnings estimates. Since FY1998 is clearly a throw-away year for Micron (the only question is: how big will losses really be?), analysts are looking to 1999 as the savior, with an overgenerous estimate of $0.86. That puts the shares at a P/E of 35 times 1999's earnings estimate. In the current semiconductor environment, that is too rich for our liking. And, since the earnings estimates are suspect to begin with, the shares are probably even more overvalued than the P/E indicates.

As analysts start to come to grips with reality and see that the stock is not worth 35 times their generous earnings estimates, there will be a mad rush for the exits. We expect to make money all the way down. Short Micron Technology (NYSE: MU). — *S.S.*

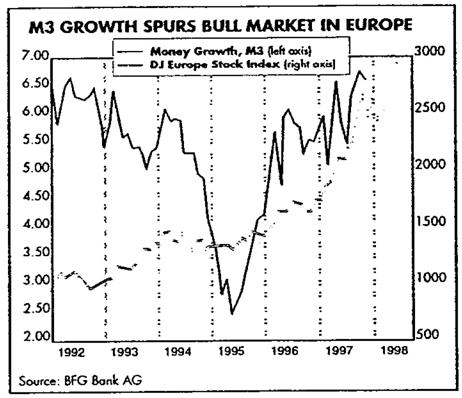
Editor's Note

Heading up the research on specific investment strategies derived from our macro view will be Stephen Sjuggerud. Steve is the research director for the Fleet Street Group (the publishers of this letter), the editor in chief of *World Money Analyst*, and the portfolio manager for *The Trader*. His investment advice has appeared in *Barron's, Bloomberg Personal, The Washington Post*, and other prestigious publications. As the former vice president of a closed-end global mutual fund, Steve combines years of serious formal study of the markets with years of hands-on, successful real-world experience.

Assisting on market research will be Doug Noland. Doug has provided us with valuable financial research of various kinds over the last two years. Doug received his MBA from the University of Oregon, and has 12 years of professional experience in financial analysis and portfolio management. — *K.R.*

(continued from page 5)

electronics industry. Recently, we have been told of massive cancellations in semiconductor capital expenditures, which is ominous for the equipment stocks including Applied Materials, KLA Instruments, and Novellus Systems. With huge losses from semiconductor manufacturer Micron Technologies, and early warnings from the likes of Dallas Semiconductor, VLSI, National Semiconductor and Motorola, industry fortunes appear to be going from bad to much worse. Importantly, the situation has deteriorated greatly in just the past two months.



After an extraordinarily long and bountiful technology boom, today a confluence of negative factors point to irrepressible profit troubles. These include the SE Asian crisis, sharply declining Japanese spending, the general commoditization of PCs and technology products, slower growth in global cellular and paging businesses, slowing demand and increased price consciousness for PCs and related hardware in the corporate market, a significant PC inventory glut, and a resulting likely sharp global pullback in capital expenditures throughout the industry. And, quite simply, after such a maniacal global investment boom, there is just way too much capacity throughout the industry. Today we see absolute guerrilla warfare as an overcrowded and overcapitalized industry fights feverishly for any market with profits.

The fact that this situation is so easily ignored by over-zealous equity investors only leaves us with additional cause for concern. If, as we suspect, today's strong demand for PCs and technology products is much reliant on the continuation of today's financial and economic bubble in the U.S. and elsewhere, we expect the inevitable bust. When the extraordinary current gap is narrowed between investors' sparkling perceptions and the actual gloomy economic and earnings prospects, the real surprise will be a collapse in demand. Today, however, even strong demand is incapable of rescuing a hopelessly overbuilt industry. To this point, investors have been quite successful in shifting to the ever-narrowing list of technology leaders, thus far largely immune from problems, that dominate the industry indexes. We don't, however, see this simple strategy as being rewarding going forward. Instead, we see few companies immune to the developing industry profit collapse

EUROPE'S MIRAGE OF FISCAL RESTRAINT

It is as if a fiscal miracle has come to pass in Europe. Less than a year ago it seemed virtually certain that the great majority of European countries would definitely fail to meet the two fiscal conditions to qualify for participation in the single currency, as stipulated for the year 1997: a budgetary deficit not exceeding three percent of GDP and total public indebtedness not exceeding 60 percent of GDP (debt-to-GDP ratio).

At the time, just three out of 15 EU states had fiscal deficits below the three percent limit. They were Denmark, the Netherlands, and Luxembourg. The general government deficit-to-GDP still averaged 4.4 percent, after 5.0 percent the year before. France and Germany had deficits of four percent of GDP, and given their anemic economic growth, it seemed a daunting task to hit the fiscal Maastricht criteria.

Last February, 14 out of the 15 EU states reported that their 1997 fiscal deficits had declined to three percent of GDP or below, and that their 1998 deficits would be lower. Provisionally, the EMU-11 states reported an average deficit of 2.6 percent of GDP, the lowest since the 1970s.

What, really, has happened to precipitate this last-minute almost-universal, dramatic improvement in Europe's fiscal stance? Did the governments at long last hit the spending brakes? In no way! As to be expected, some countries have resorted to statistical fudging and questionable one-off policy moves. These include the transfers from France Telecom (equivalent to nearly 0.5 percent of GDP) and the so-called euro tax in Italy (roughly 0.6 percent of GDP).

But the key factor behind this magical shrinkage of the public deficits was the broad collapse in short-term and long-term interest rates over the last two years. It provided all governments with huge windfall savings in

their debt costs, cutting them according to calculations by Goldman Sachs on average by about 1.1 percentage points of GDP and accounting thus for the bulk of the sharp decline in their fiscal deficits. In the absence of these gains, most countries would have missed the deficit target by a substantial margin.

Between 1995 and 1997, short-term rates fell among the EU states on average by 230 basis points and long-term rates by 250 basis points. By far the biggest gains accrued, of course, to the so-called peripheral countries, Italy, Spain, and Portugal, where rates plummeted by 500 basis points and more.

Overall, as earlier mentioned, the average EU deficit is down from 4.4 percent of GDP in 1996 to 2.6 percent in 1997. Of this 1.8 percentage point shrinkage of deficits, interest savings accounted for 1.1 percentage points, or well over half the decrease. In the case of Germany, the savings were 1.2 percentage points of GDP, which was well in excess of the overall deficit reduction from 3.5 percent in 1995 to 2.7 percent of GDP.

What, after all, salvaged the common currency was not really painful fiscal restraint but the painless plunge in interest rates and debt costs, implemented by loose monetary policy and euphoric global bond markets.

Evidently, the higher a country's debt ratio and its prior interest levels, the steeper the fall in interest rates, and the bigger the resulting savings in interest expenditures. Inherently, the high-yielding currencies have profited twofold: first, from the general steep decline in interest rates; and second, from the collapse of the former sizable interest spreads. Presently, spreads over Bund yields are 19 basis points for Italy and 9 basis points for Spain.

For the eleven countries, participating now in the first wave of EMU, each percentage point change in interest rates translates into an average decrease or increase of the government's interest bill of 0.75 percentage points. For Belgium and Italy, with the highest debt levels, the associated interest effect comes to about 1.25 percentage points. It goes without saying that this leverage of changes in interest rates on debt costs works with the same vigor in the opposite direction, when interest rates will rise.

THE ROOT PROBLEM REMAINS UNTOUCHED

The critical role of plunging debt costs in fulfilling the fiscal EMU entry conditions essentially demolishes the prevailing perception in the markets that the economic sluggishness in continental Europe over the past years was largely due to the fiscal austerity which the Maastricht treaty had imposed on EMU aspirants.

Deficit cuts, largely resulting from plunging interest rates and debt costs, hardly exert any economic restraint. Given at the same time rapidly accelerating broad money growth, the two together are, quite to the contrary, compelling evidence of an extremely loose overall policy stance. But the troubling point is that this policy looseness had greatly disappointing effects on the economies while hyper-stimulating the financial world. We don't see any significant change in this deficiency.

It is our long-held opinion that the narrow focus of the Maastricht treaty on the annual fiscal deficits was grossly inadequate. In practice, it worked out as an invitation to more tax increases and as a barrier to badly needed tax cuts. Above all, the deficit target ignored the one number that really encapsulates Europe's root problem: the exorbitantly high percentage of output and incomes which the governments preempt and redistribute through their profligate taxing and spending policies. For some time already, it is widely accepted wisdom that Europe's overgenerous welfare state needs substantial trimming. Yet, very little or almost nothing of that sort has been done. Deliberate measures to reduce the deficits were, instead, concentrated on capital expenditures and tax increases.

Although there are important differences between countries, the average government expenditure ratio in the EU has soared from 37 percent in 1970 to about 50 percent in 1996. At the same time, the average share of government receipts in GDP swelled from 37 percent to 46 percent. In the United States, the two components have during this time been stagnating at around 32 percent of GDP, and in Britain at around 42 percent of GDP.

STRONG OR WEAK EURO?

The euro, with eleven participating countries, is all but upon us. We have often enough expressed and explained that we are radically opposed to it both for economic and political reasons. Accepting it now as inevitable, we hasten to emphasize, though, that our concern is not at all a revival of inflation in Europe but the persistence of sub-par economic growth and in its wake chronic mass unemployment, essentially associated with very low inflation rates. Overall, this makes an economic mixture that tends more toward deflation than inflation.

But currency strength has implicitly internal and external sides. Internally, it means low inflation, while externally, it means strength against other currencies, in particular against the U.S. dollar, which, in turn, may be fundamentally or cyclically weak. In other words, a weak dollar would also make a strong euro.

Fundamentally, the external strength of a currency is in the long run determined by the weakness or strength of its balance of payments in current account, reflecting excess spending or excess savings. In reality, though, there are frequent, prolonged exceptions to this rule which fortunately have a regular and therefore predictable pattern.

The force behind these exceptions are sharp fluctuations in capital flows dwarfing the fluctuations in the current account. In turn, the ups and downs of U.S. capital inflows are highly related to the ups and downs of the U.S. business cycle vis-à-vis the European business cycle and the corresponding interest rate differentials.

Appraisal of a currency's strength should nevertheless start with a country's current account as a major source of its external supply. But the final clue lies in the cyclical rhythm of capital flows between countries in differing stages of the business cycle. Over the last three years, the U.S. current-account deficit has surged from $129 billion to $171 billion. Yet, because capital inflows swelled faster than the current-account deficit, the dollar staged a strong recovery in the currency markets, indicating that the capital inflows exceeded the needs of the current-account deficit.

For the reasons explained, the U.S. trade and current-deficit is expected to widen dramatically in the course of this year. According to OECD estimates, it will in 1998 hit a new high of $213 billion, as against a surplus of $137 billion surplus on the part of the EU bloc, both with a rising trend. Trying to assess how this substantial trade deterioration will affect the dollar, its reverse side of course being a strong euro, the decisive question to ask is whether or not the capital inflows will grow fast enough to overtake the big rise in the current deficit. We are convinced they will not. It might be possible, if the U.S. economy and its financial markets would continue to boom. But any weakness in the economy or in the financial markets, tending to slow the capital inflows, is poison for the dollar.

In many respects, the present dollar strength (respectively, the weakness of the European currencies) is the mirror-image of the development in 1983-85, when pessimism about the European economies (eurosclerosis) combined with a perception of the superior dynamism of the U.S. economy, symptomized by interest rates far above those in Europe.

Trying to draw lessons for the present, we have our eyes not only on the dollar but also on the British pound. The strength of both currencies in recent years conforms perfectly with the described cyclical concept that the moves of the major currencies against each other are governed by diverging national or regional business cycles and their impact on international capital flows.

Back to our earlier question of currency prospects. Strictly speaking, we are not at all bullish on the European economies. But we are looking out for the topping out of the British and the U.S. business cycles as the precursor of a sharp decline of the two currencies. Given the large, chronic U.S. trade deficit, obviously reflecting overconsumption, the dollar remains fundamentally a weak currency.

THE U.S.-EUROPEAN JOB PUZZLE

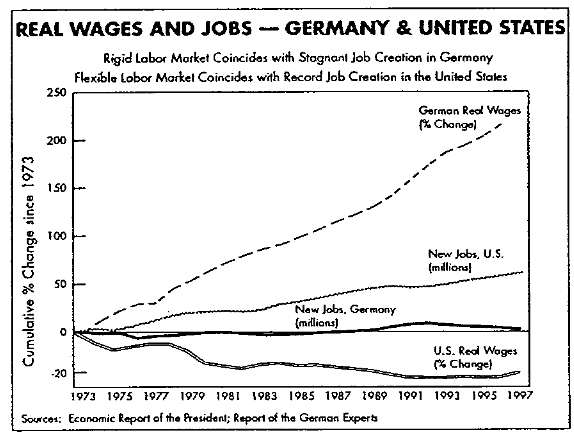
In Europe, expectations are running high that a golden mix of modestly faster economic growth and the lowest inflation and interest rates in thirty years are heralding a healthy start for EMU. Unfortunately, little else looks healthy, considering that the wage and tax problems fostering mass unemployment have in general barely been touched. Besides, we notice in the forecasts a distinct difference between verbal euphoria and numerical sobriety. Consensus projections for EMU bloc growth vary between 2.5 and three percent, compared with 2.6 percent in 1997.

Yet by the modest standards of the 1990s, these growth rates appear pretty impressive. For the first time in years, European economic growth might well equal or even surpass that of the U.S. economy, being on its part projected at 2.7 percent in 1998. All the more striking is the sweeping differences in employment growth.

During the 1990s, annual real U.S.GDP growth has averaged 2.6 percent. Its lustrous collateral was the creation of 12.2 million new jobs. Over the same time span the European Union had average annual real GDP growth of 2.2 percent. But instead of job growth, there were considerable job losses, running into several millions. The EU unemployment rate soared from 8.5 percent to over 12 percent.

The plain, hard fact is that the United States and Europe have extremely different growth structures. In the United States, job creation starts at about one percent economic growth. For the European Community the job threshold lies at two percent economic growth, if not higher. Adding the growth in the labor force, unemployment only begins to decrease when annual economic growth exceeds 2.6 percent. In the United States, this growth rate implies an employment boom.

What's more, this correlation between economic and employment growth in Europe has dramatically deteriorated in the last years for a manifest reason. And that is the fact that the EMU bloc's upturn is singularly geared to export and inventory growth, which exclusively benefit the manufacturing sector, the output of which has the smallest labor content.



REAL WAGES AND JOBS — GERMANY & UNITED STATES

Germany's recent experience most strikingly exemplifies this trend. Economic growth in the last two years derived literally in full from exports and inventories. The essential supplier of the goods was the manufacturing sector, which thus enjoyed strong growth within an otherwise stagnating economy. So far, so good, but the calamity to employment arises from the fact that this sector of the German economy operates currently with more than six percent annual productivity growth. It enabled the manufacturing firms to boost their output and yet slash more than 600,000 people from their payroll.

Virtually the same imbalanced growth pattern has been true for a large part of the European Union. Export growth is the fastest in over 20 years, as compared with very little or no pick-up in aggregate final domestic demand. It should be clear that this kind of lopsided growth pattern is neither desirable nor sustainable.

EUROPE'S TWO ROOT PROBLEMS: WAGES AND TAXES

But what is it that is driving this persistent wedge in productivity growth between the economies of Europe and the United States? In short, various decades of grossly differing wage levels and wage trends. What has been happening to employment on both continents used to be known in economics as the Ricardo Effect . It is the contention that high wages relative to the price level for products foster the substitution of machinery for labor ultimately at the expense of employment, with higher productivity growth as its corollary. The higher the wages, the more profitable such a shift.

As explained, U.S. economic growth has a high labor content, and European growth an unusually low labor content. Both trends conform perfectly with the Ricardo Effect, albeit working in opposite directions. Given the decade-long surge in wage costs, European business adapted to the increasingly expensive labor factor by making as economical use of it as possible. In the long run, ever-higher wages rates essentially ended up in ever-lower wage sums.

To improve its unemployment situation, Europe is principally faced with two choices: either it must achieve much higher economic growth, or it must aim to make its given economic growth more labor-intensive, like in the United States.

Realization of the first option implies a major rise in the investment share in GDP and a concomitant fall in the government and tax share. Politically, this has no chance of happening. The alternative would be to make the given growth rate of GDP more labor-creating by a gradual reduction in real wages associated with a downward widening of the wage scale and reform measures to make the labor markets more flexible. There is some tinkering in this respect, but no strategy. Relentlessly rising mass unemployment will haunt Europe and the euro.

CONCLUSION

Globally, a tug of war is being waged by powerful contractive and deflationary forces on one side (Far East Asia) and the still-booming U.S. economy on the other. The balance should tip the global economy towards sharper-than-expected weakness.

Asian currency and stock markets have rebounded, but the economies are going from bad to worse, strangled by powerful credit crunches, a surge in capital costs, and massive wealth destruction in the asset markets. The Asian crisis will impact G7 economic activity, profits, and prices through three channels: sharply lower imports, higher exports, and intensified global competition.

Yet what will clinch the outlook for the global economy and financial markets in 1998 is the double whammy to the U.S. economy provided by the strong dollar and the future Asia fall-out. As a result, we look for a sharp slowdown in U.S. GDP growth in the second half of this year below two percent at annual rates. In addition to the savage trade shock, there has been an ominous decline in investment spending.

U.S. cyclical weakness, as explained, makes regularly for a weak dollar. In combination with a drastically widening U.S. trade gap, it heralds even more: a plunging dollar. Dollar bulls and dollar bears, keep a keen eye on U.S. economic data.

That's the one reason why we favor bonds in Europe's hard currencies. The other one is the virtual disappearance of the medium-and longer-term yield spreads between core and peripheral Europe. Future turmoil within EMU appears to us possible, if not probable. ■

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